

A REVIEW OF TAX LAW CHANGES

Enacted by the 2005 General Assembly

NOTE: This 2005 legislative summary presents only general information concerning the major tax provisions the General Assembly has enacted and does not represent a complete analysis or specific interpretations of the law changes. The Department of Revenue will provide more specific information as it implements these changes. Full text of enacted bills is available on the legislative home page, www.lrc.ky.gov.

The 2005 Kentucky General Assembly created, amended or repealed numerous statutes. A total of 743 bills and 308 resolutions were introduced. In the end, 172 became law for an enactment rate of 23.15%. The Governor vetoed one bill and 13 items in the budget bill.

Eighteen bills had substantive tax implications, with some affecting more than one tax. This review describes the tax portion of each bill. Effective dates are shown when specifically stated in the legislation. Otherwise, the changes are effective June 20, 2005.

ADMINISTRATIVE

Electronic Records – Department of Revenue auditors may request taxpayer records in an electronic format when taxpayers already have them in such a format. **(HB 497)**

Fraud – The definition of “fraud” is clarified to mean not only a taxpayer’s failure to file required information, but also a taxpayer’s intentional filing of false information. **(HB 497)**

Utility Gross Receipts License Tax – The utility gross receipts license tax, which the Department will begin administering for local school districts in July 2005, is required to be filed and paid electronically. A taxpayer may request a waiver of this requirement. The bill also permits the Department of Revenue to share utility gross receipts license tax information with the school districts on a confidential basis. **(HB 497)**

Refund Claims – This bill amends various statutes to clarify that a taxpayer must file an individual refund claim setting forth the specific grounds upon which the refund claim is based, that tax refund claims may not be obtained by a class action lawsuit, and that the filing of a class action lawsuit does not constitute the timely filing of a refund claim for each member of the alleged class. **(HB 498)**

Department of Revenue Reorganization – The Revenue Cabinet is abolished and Department of Revenue within the Finance and Administration Cabinet is created. The bill also establishes major divisions within the Department of Revenue. **(SB 49)**

ALCOHOLIC BEVERAGES TAX

Increase – (Effective June 1, 2005) Alcohol wholesale tax is increased from 9 percent to 11 percent. **(HB 272)**

CORPORATION INCOME TAX

Corporation Income Tax Base Expansion – (Effective for tax periods beginning on or after January 1, 2005) The corporation income tax base is expanded to include all limited liability entities (corporations, LLPs, LLCs, including single member LLC's, limited partnerships, and S corporations). General partnerships and sole proprietorships will not be subject to the expanded corporation income tax. Publicly traded partnerships and their limited partnership and limited liability company affiliates will be taxed as general partnerships. There is no pass-through of income, loss or credit to non-individual owners of pass-through entities subject to corporation income tax. Individual partners, members or shareholders of pass-through entities subject to corporation income tax will receive credit for tax paid at the entity level. **(HB 272)**

Rate Reduction – (Effective for tax periods beginning on or after January 1, 2005) The top corporate rate is reduced and lower brackets expanded. The 4 percent bracket applies to taxable net income up to \$50,000, and the 5 percent bracket applies to taxable net income between \$50,000 and \$100,000. For taxable years beginning on or after January 1, 2005, and prior to January 1, 2007, the top corporate rate will be 7 percent on all taxable net income over \$100,000. For tax years beginning on or after January 1, 2007, the top rate will be 6 percent on all taxable net income over \$100,000. **(HB 272)**

Reference to Internal Revenue Code – (Effective for tax periods beginning on or after January 1, 2005, except where otherwise indicated) The Internal Revenue Code reference date is updated to December 31, 2004, except that depreciation and Section 179 expenses are calculated based on the Code in effect on December 31, 2001. By updating the reference date, Kentucky's tax laws conform more closely with federal laws, providing ease of filing for taxpayers and ease of administration for the Department of Revenue. **(HB 272)**

Alternative Minimum – (Effective for tax periods beginning on or after January 1, 2005) Taxpayers must pay the greater of the income tax, the alternative minimum tax, or \$175. Taxpayers can choose between two methods to calculate the alternative minimum: 9.5 cents per \$100 of the corporation's gross receipts, or 75 cents per \$100 of the corporation's Kentucky gross profits. Kentucky gross profits means Kentucky gross receipts reduced by returns and allowances attributable to Kentucky gross receipts, less Kentucky cost of goods sold. Cost of goods sold includes direct labor and the cost of specialized transportation for gasoline and special fuels. **(HB 272)**

Mandatory Nexus Consolidated Returns – (Effective for tax periods beginning on or after January 1, 2005, except as otherwise noted) All corporations with nexus in Kentucky that are connected through an ownership interest of 80 percent or more must file a consolidated Kentucky return. This includes the expanded definition of corporation, with limited liability entities included in the affiliated group. **(HB 272)**

Intangible Property, Management Fees, Other Related Party Expenses - Certain deductions relating to transactions with one or more related members of an affiliated group may be disallowed unless:

1. The corporation and the related member are included in the same consolidated Kentucky corporation income tax for the relevant taxable year; or

2. A disclosure is made and evidence provided to establish that the transaction was at arm's length, that the payment made to a related member was subject to income tax in another jurisdiction or the related member has substantial business activities other than the management or ownership of intangible property; or
3. The Department of Revenue and taxpayer agree in writing to an alternative method of apportionment. (*HB 272*)

“Doing Business” Nexus Standard – (Effective for tax periods beginning on or after January 1, 2005) The standard in Kentucky changes from a physical presence standard to a “doing business” standard. (*HB 272*)

Net Operating Losses -- (Effective for tax periods beginning on or after January 1, 2005) Corporations may no longer carry NOL's back to previous years. (*HB 272*)

Multiple Taxing Jurisdictions (Apportionment) – (Effective for tax periods beginning on or after January 1, 2005) All limited liability entities subject to corporation income tax that do business within and without Kentucky and general partnerships that do business within and without Kentucky will be required to utilize a 3-factor apportionment formula to apportion income to Kentucky. (*HB 272*)

Phase II Tobacco Payments – (Effective for tax periods beginning on or after January 1, 2005) State funds that may be paid out as an addition to or a replacement of Phase II tobacco payments are exempt from corporation income tax. (*HB 272*)

Conversion – An ordinary corporation may convert to a nonprofit, nonstock corporation under KRS Chapter 273. (*SB 142*)

CORPORATION LICENSE TAX

Repeal – (Effective for tax periods ending on or after December 31, 2005) The corporation license tax is repealed. Returns and tax for prior periods remain due. The anticipated increases resulting from the Illinois Tool Works court decision, 00-CI-623, will not apply for any year. (*HB 272*)

ECONOMIC DEVELOPMENT INCENTIVES AND CREDITS

New limits on Kentucky Investment Fund Act (KIFA) Credits – (Effective July 1, 2005) Kentucky Investment Fund Act tax credits available to any single investment fund are limited to \$1,300,000 for all investors and all taxable years. Total KIFA tax credits available for all investors in all investment funds shall not exceed \$5,000,000 per fiscal year. (*HB 267*)

Clean Coal Incentive Credit – (Effective for tax periods beginning on or after December 31, 2006) A potential credit is available to an electricity generation facility certified as using clean coal equipment and technology and burning coal subject to Kentucky's severance tax. The credit may be taken against corporation income, individual income, and public service property taxes at the rate of \$2 per ton of qualifying coal burned. The credit applies to electricity generation

facilities with an investment of more than \$150 million that meet Natural Resources and Environmental Protection Cabinet standards. **(HB 272)**

Environmental Remediation (Brownfields) Credit – (Effective for tax periods beginning on or after December 31, 2004) Taxpayers who agree to clean up or develop an existing abandoned brownfield area may qualify for a credit against corporation or individual income taxes in a maximum amount of \$150,000. **(HB 272)**

Environmental Stewardship Credit – (Effective for tax years ending on or after January 31, 2007) A credit against the corporation and individual income taxes for a corporation or individual that undertakes an environmental stewardship project with a minimum investment of at least \$5 million is available. The Cabinet for Economic Development approves the projects. The taxpayer must meet certain wage requirements in order to qualify. The credit will cover 100 percent of eligible skills upgrade training costs and up to 25 percent of eligible equipment costs. The project must produce an environmental stewardship product, which is defined to mean a new manufactured product or substantially improved existing manufactured product that has a lesser or reduced adverse effect on human health and the environment, or provides for improvement to human health and the environment when compared with existing products or competing products that serve the same purpose. The maximum amount of credit claimed for any single fiscal year may not exceed 25 percent of the total authorized inducement. **(HB 272)**

Biodiesel Credit – (Effective for tax periods beginning on or after January 1, 2005) Credits may be taken against corporation or individual income taxes for producing or blending biodiesel fuels of up to \$1 per gallon produced or blended, limited to a maximum state-wide credit of \$1.5 million. The credit may not be carried forward. **(HB 272)**

Recycling Tax Credits – (Effective for tax periods beginning on or after December 31, 2004) Corporation and individual income taxes recycling credits available are expanded for major recyclers who make a significant investment in plant and equipment and who meet certain employment standards. Credits are allowed for up to 50 percent of the cost of new and expanded recycling equipment, limited each taxable year to 50% of the total tax liability for the year the credit is claimed over the tax liability for the most recent taxable year ending prior to January 1, 2005 or \$2.5 million, whichever is lesser. This bill also provides for the recapture of the credit if the equipment is no longer used in a qualifying manner or is sold or disposed of within five years from the date it is purchased, based upon the useful life of the equipment and year of disposition. An exception to the recapture exists in the case of transfers due to death or change in business ownership or organization as long as the equipment remains qualifying equipment. **(HB 272)**

Historic Preservation Credit – (Effective for tax periods ending on or after December 31, 2005) This bill allows a credit against corporation or individual income taxes for a portion of the cost of restoring a qualified residential and commercial structure listed on the National Registry of Historic Places. The credit is equal to 30% of the rehabilitation expenses, in the case of owner occupied residential property, and 20% of the rehabilitation expenses, in the case of all other property. The total credit available is capped at \$3 million annually, with each individual owner-occupied property receiving no more than \$60,000.

ENTERPRISE INITIATIVES

Enterprise Initiative Act – (Effective January 1, 2006) A new statewide tax incentive program replaces the Enterprise Zone program. It extends to eligible companies the opportunity to receive refunds of sales and use tax paid on the purchase of building materials and research and development materials. The bill limits eligible expenditures to tourist attractions, services, technology, manufacturing, and company headquarters in any industry. The plan gives preference to companies in existing enterprise zones; the minimum investment is \$100,000 for companies within enterprise zone boundaries; \$500,000 elsewhere. It also creates a state-wide cap in each year of \$20 million for building materials and \$5 million for research and development on all approved projects. *(HB 272)*

HEALTHCARE PROVIDER TAX

Nursing Homes – (Retroactive to July 1, 2004) All state operated veterans' nursing homes are excluded or exempted from paying health care provider tax. *(HB 439)*

Classifications – (Effective July 1, 2005) Three new classifications to health care provider tax base are created: regional community mental health and retardation services (taxed at 4 percent of gross revenues received), psychiatric residential treatment facility services and Medicaid managed care services (taxed at 5.5 percent of gross revenues received). *(HB 461)*

INDIVIDUAL INCOME TAX

Reference to Internal Revenue Code – (Effective for tax periods beginning on or after January 1, 2005, except where otherwise indicated) This bill updates the Internal Revenue Code reference date to December 31, 2004, with three exceptions, as the basis for Kentucky income taxes. The exceptions are: 1) for property placed in service after September 10, 2001, only the depreciation and expense deductions allowed under Sections 168 and 179 of the Internal Revenue Code in effect on December 31, 2001, exclusive of any amendments made subsequent to that date, shall be allowed; 2) the provisions of the Military Family Tax Relief Act of 2003, Pub. L. No. 108-121, are effective on the dates specified in that Act; and 3) Kentucky will not allow the deduction for sales and use taxes in lieu of state income taxes. By updating the reference date, Kentucky's tax laws conform more closely with federal laws, providing ease of filing for taxpayers and administration for the Department of Revenue. *(HB 272)*

Family Size Tax Credit– (Effective for tax periods beginning on or after January 1, 2005) Low-income taxpayers will have increased relief. The current low-income tax credit is repealed for taxable years beginning on or after January 1, 2005. The new Family Size Credit is based on modified gross income (MGI) and size of the family household up to four members. Single and married taxpayers whose MGI is at or below federal poverty level for the family size will receive 100% tax credit. For 2005, MGI levels that qualify for the 100% tax credit are as follows:

Size of Family Unit	Amount
1	\$ 9,570
2	\$12,830
3	\$16,090
4	\$19,350

The Family Size Tax credit provides benefit to individuals and families at incomes up to 133 percent of the federal poverty level, through a phase-down of the credit. **(HB 272)**

Rate Reduction – (For taxable years beginning after December, 31, 2004) The tax rate for taxable income between \$8,000 and \$75,000 drops to 5.8 percent with taxable income over \$75,000 continuing to be taxed at 6 percent. **(HB 272)**

Net Operating Losses -- (Effective for tax periods beginning on or after January 1, 2005) Individuals may no longer carry NOL's back to previous years. **(HB 272)**

Phase II Tobacco Payments – (Effective for tax periods beginning on or after January 1, 2005) State funds that may be paid out as an addition to or a replacement of Phase II tobacco payments are exempt from individual income tax.

Pensions – (Effective January 1, 2005) The pension exclusion is capped at \$41,110, the 2005 amount, and KRS 141.105, which provided for the cost of living adjustment, is repealed. **(HB 272)**

Education Tuition Tax Credit – (Effective for tax periods beginning on or after December 31, 2004) A credit equal to 25 percent of the amount of the federal Hope Scholarship and the lifetime learning credit is available. The credit applies only to undergraduate studies, phases out for higher incomes, and applies to most higher education opportunities within Kentucky. **(HB 272)**

Health Savings Accounts – (Effective for tax periods beginning on or after January 1, 2005) As a part of the Internal Revenue Code update, Kentucky allows the same tax advantages currently available at the federal level for health savings accounts. Benefits include permitting pre-tax treatment of contributions to health savings accounts, and more potential uses of funds than are allowed with flexible spending accounts. **(HB 272)**

Refund Designation - Taxpayers may now contribute all or a portion of their individual refund to The Breast Cancer Research and Education Trust Fund. The fund replaces the Bluegrass State Games and U. S. Olympic Committee Fund on the Kentucky Individual Income Tax Returns. **(HB 7)**

MOTOR FUELS TAX

Refunds – A motor fuels refund may only be requested on fuel purchased after the effective date of the refund permit. **(HB 494)**

Underground Storage Tank Fees – The underground storage tank fee exclusion extends to include all the special fuels for which a credit is provided for by KRS 138.358. **(HB 494)**

Bulk Sales – The motor fuels exemption for sales to the federal government is clarified as applying only to bulk sales and not retail sales. **(HB 494)**

Payments – Motor fuels dealers in good financial standing may either pay by a dealer's check or electronic funds transfer payments. *(HB 494)*

Financial Instruments – Substitutes the words "bond(s)" for "financial instrument(s)" in HB 662, 2002 Session. *(HB 494)*

Average Wholesale Price of Gas – For purposes of the motor fuels tax calculation, the "average wholesale price" is deemed to not be less than one dollar and twenty-two cents (\$1.22) per gallon; amended from one dollar and eleven cents (\$1.11) per gallon. *(HB 267)*

MOTOR VEHICLE USAGE TAX

Collection of Motor Vehicle Usage Tax at Titling – (Effective July 1, 2005) Collection of motor vehicle usage tax is required when an owner titles rather than registers, a vehicle. Allows an owner to submit an affidavit of non-highway use to prevent payment of motor vehicle usage tax on vehicles that will not be operated on Kentucky highways. Requires collection of sales and use tax on vehicles not used on the highway. Provides credit against motor vehicle usage tax for Kentucky sales and use tax paid when an affidavit is submitted. *(HB 267)*

Charter Buses – (Effective August 1, 2005) Charter buses are exempted from the motor vehicle usage tax. *(HB 267)*

PARI-MUTUEL TAX

International Horse Racing Events – (Effective from January 1, 2001, to January 1, 2006) An excise tax will not be imposed on pari-mutuel wagering on live racing occurring on any one day that a Kentucky track hosts an international horse racing event that distributes in excess of \$10,000,000 in purses. This tax exemption would remain in effect for any such succeeding event if the event returns within three years of the previously held event. *(HB 350; HB 497 (Effective January 1, 2006))*

PROPERTY TAX

Property Owned by Another State – (Effective July 1, 2005) All real and personal property owned by another state and used exclusively for public purposes is exempt from taxation if that state comparably exempts the Commonwealth's property. *(HB 267)*

Local School Districts – (Effective July 1, 2005) Local school districts which are deemed "hold harmless" pursuant to fiscal year 2005-2006 Support Education Excellence in Kentucky (SEEK) tentative calculation shall not be required to levy a property tax rate lower in fiscal year 2005-2006 than the previous year's rate.) *(HB 267)*

Intangible Property Tax Repealed – (Effective January 1, 2006) Most intangible property taxes are repealed, other than some of the intangible taxes paid by financial institutions and other businesses. *(HB 272)*

State Real Property Tax Rate – (Effective for tax years beginning on or after January 1, 2005) Revenue and assessment growth resulting from new property is excluded from the 4 percent growth limit established by HB 44. *(HB 272)*

School Funding – (Effective for assessments on or after January 1, 2006) A district board of education may levy a general tax rate that will produce revenue from real property, exclusive of revenue from new property, that is 4 percent over the amount of revenue produced by the compensating rate as defined in KRS 132.010. *(HB 272)*

Biotechnology Products – (Effective January 1, 2002) Biotechnology products are exempted from assessments for local property taxes, and provides a definition of biotechnology products *(HB 308)*

Barge Lines – (Effective January 1, 2001, to January 1, 2006) This bill simplifies the ad valorem reporting by and payment requirements of affected commercial watercraft companies. *(HB 350)*

School Tax Recall – (Applies to orders, ordinances, resolutions, or motions passed after July 15, 2005) A school tax recall petition in a district in a consolidated local government must include 5 percent of registered and qualified voters voting in the last presidential election. Each sheet must include names of voters from one precinct and an invalid signature shall not disqualify the entire page but result in striking the invalid signature only. *(SB 13)*

Airport Authorities – KRS 382.135 now exempts deeds conveying real property to airport authorities from certain filing requirements. *(SB 111)*

Environmental Remediation (Brownfields) Incentive – (Applies to tax years beginning on or after January 1, 2005) This bill reduces the real property tax rate to \$.015 per \$100 of value for approved properties for 3 years. *(HB 272)*

SALES & USE TAX

Donated Goods -- (Effective August 1, 2005) A sales tax refund equal to 25 percent (up to \$1 million) of the tax collected on sales of donated goods by resident nonprofit educational, charitable or religious institutions is available, if the entity uses the refund exclusively as reimbursement for capital construction costs of additional retail locations in this state. *(HB 267)*

Repair and Replacement Parts for Charter Buses – (Effective August 1, 2005) Repair and replacement parts for directly operating and maintaining a charter bus the Transportation Cabinet certifies are exempt. *(HB 267)*

Vendor Compensation – (For tax periods after June 30, 2005) The compensation a taxpayer may receive for collecting and remitting sales and use tax is limited to \$1,500 per month. *(HB 267)*

Commercial Printers or Mailers – (Effective July 1, 2005) Commercial printers or mailers engaged in business in this state are not required to collect use tax on sales of printing or direct mail advertising materials that are both printed out of state and delivered out of state to the postal service for mass mailing to third-party Kentucky residents who do not purchase the advertising materials. *(HB 267)*

Natural Gas – (Effective June 1, 2005) The sales and use tax is levied upon distributing, transmitting, or transporting natural gas for storage, use or other consumption in this state, excluding natural gas classified for residential use or to a seller or reseller of natural gas. Charges for related distribution, transmission, and transportation for energy that is billed to the user will be included in the cost of production when calculating the 3 percent cost of production for Energy Direct Pay. *(HB 267)*

Water Withdrawal Fees – (Effective July 1, 2005) The Department of Revenue may not subject water withdrawal fees imposed by the Kentucky River Authority to state and local taxes. *(HB 267)*

Breeder Incentives – (Effective June 1, 2005) Sales tax receipts from stud fees for breeding of horses in this state are earmarked for use in creating breeder incentives. The sales tax will be deposited into special funds for future disbursement by the Kentucky Horse Racing Authority. *(HB 272)*

Nexus – (Effective August 1, 2005) The sales tax nexus standard will broaden to include remote sellers who use in-state affiliates to facilitate remote sales. This change specifically addresses remote sellers (mail-order and internet) who allow returns to be made to an affiliated store or location within Kentucky. *(HB 272)*

Study – (Findings to be reported December 1, 2006) Legislative Research Commission will study the effectiveness of sales tax exemptions. *(HB 272)*

Streamlined Sales Tax Agreement – (Effective July 1, 2005) Various sections of KRS Chapter 139 are amended to conform to the Streamlined Sales and Use Tax Agreement. The bill also amends KRS 139.472 to exempt mobility enhancing equipment from sales and use tax. *(HB 495)*

County Fair Admissions -- The first \$50,000 in county fair admissions are exempt from sales and use tax. *(HB 497)*

Telephones/Pay Phones (See Telecommunications Services) – (Effective January 1, 2006) Switch access and pay phone receipts are no longer subject to sales tax. *(HB272)*

TELECOMMUNICATIONS SERVICES

Excise Tax – (Effective January 1, 2006) An excise tax of 3 percent is imposed on multichannel video and audio programming services. Telephone services remain subject to the sales and use tax at a rate of 6 percent. Local governments will receive a guaranteed, fixed amount to replace the franchise fees and unit valuation property taxes that they will no longer receive. (*HB 272*)

Gross Revenues Tax – (Effective January 1, 2006) An internal gross revenues tax is levied against telephone providers at a rate of 1.3 percent of gross revenues, and against multichannel video and audio programming providers at a rate of 2.4 percent of gross revenues. (*HB 272*)

TOBACCO TAXES

Cigarettes – (Effective June 1, 2005) A 26-cent-per-pack surtax is added to the existing excise tax of 3 cents per pack. Vendor compensation remains based on the previous, rather than the increased, amount, except that an additional allowance for six months will follow the imposition of the surtax. (*HB 272*)

NOTE: An additional one cent cigarette tax levy is in *HB 267*, the budget bill, which will be deposited in a special fund to be matched by the University of Kentucky and the University of Louisville, to be used for cancer research.

Inventory Floor Tax – (Encompasses products on the shelf and in facilities on May 31, 2005) An inventory floor tax is imposed on cigarettes and allows for payment of the tax in three equal installments over a three-month period. (*HB 272*)

Other tobacco products – Effective August 1, 2005, a 7.5 percent gross receipts tax is imposed on other tobacco products of any wholesaler derived from wholesale sales of other tobacco products, except snuff, made within the Commonwealth and \$0.095 per unit of snuff. (*HB 272*)

Cigarette compensation – (Effective June 1, 2005, to November 30, 2005) Additional compensation, for a limited time, equal to 12 cents face value for each \$3 of tax evidence purchased at face value on or after June 1, 2005 and before December 1, 2005 is allowed. The additional compensation shall sunset 12 midnight November 30, 2005. The qualifying compensation is limited to 150 percent of the amount of stamps purchased for the period of December 1, 2004 and ending before May 31, 2005. (*HB 272*)

Tobacco Research Trust Fund – The tobacco research trust fund will receive at least \$3,140,000 regardless of whether the half-cent cigarette tax levy produces that amount. (*HB 497*)

TOURISM

Transient Room Tax – (Effective June 1, 2005) A 1-percent state transient room tax on all room charges statewide in addition to the current 6 percent sales tax is created. Funds generated from the tax are deposited in a new fund separate from the General Fund. Language in the bill delineates the use of funds generated by this tax. (*HB 272*)

State or National Parks – Enhanced tourism development credits are available for facilities in state or national parks. (*HB 497*)

Boxing and Wrestling – The gross receipts tax on broadcast, television, or motion picture rights for boxing and wrestling matches is repealed. (*HB 272*)

UTILITY GROSS RECEIPTS LICENSE TAX

Utility Gross Receipts License Tax – (Effective July 1, 2005) New language adds direct satellite broadcast and wireless cable service to the tax base for school districts that impose the tax on cable services on or after July 1, 2005. (*HB 272*)